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## Post-privatisation changes in management control, firm activities and performance

Redda, B.M.

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*Document Version*

Publisher's PDF, also known as Version of record

*Publication date:*

2007

[Link to publication in University of Groningen/UMCG research database](#)

*Citation for published version (APA):*

Redda, B. M. (2007). *Post-privatisation changes in management control, firm activities and performance: the case of Eritrea-based firms*. [Thesis fully internal (DIV), University of Groningen]. s.n.

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## 6 Changes in the MCS practices, firm activities and performance of Asmara Wine & Liquor Factory (AW&LF)

This chapter examines impact of privatisation on the Asmara Wine & Liquor Factory. First, we will introduce the case firm, its production process and its administration. After that we will discuss our findings in chronological order. The first section deals with the changes straight after the introduction of the privatisation process until the end of 2002. The second part addresses the developments from 2003 until mid 2005. Our main focal points are the implementation of the firm's business and investment plans, MCS change, and changes in the firm's activities and performance. As with our first case firm, we have included the influence of internal and external contextual factors. We will end this chapter with a summary and a conclusions section.

### 6.1 Introduction and background of the factory

The Asmara Wine & Liquor Factory PLC (AW&LF) is a small-scale firm located in Asmara Zone 4, Sub-Zone 01. Formerly it consisted of two enterprises owned by two Italians, Fenili and Vitale. The companies were established in 1942 and 1947 respectively, with the objective to offer alternatives to import products, such as wines, liquor, syrups and aperitifs. Following the nationalisation of the economy in 1975, the firms of Fenili and Vitale were merged under the trade name of "Asmara Wine & Liquor Factory". The firm is ideally located for the production of beverages.

The company has two buildings in two different blocks. One is the Ex-Fenili building, which accommodates the offices of the firm's general management, the finance, administration and sales departments, the stores, and the production lines of wine and syrup. The second building is the Ex-Vitale building, where the liquor and aperitif are manufactured. A Street called Menelik II Avenue separates the two buildings. The fixed assets of the firm include buildings, equipment, vehicles, and office furniture. Prior to privatisation, at 31 December 1996, the total value of the fixed assets was 1.306 million Nakfa. At that time, however, the firm's value was depreciated by 88%, resulting in a book value of 12%. Therefore, there was an urgent need to renovate the buildings and replace the remaining assets. On 13 May 1999, AW&LF was privatised for a total sale value of Nakfa 10,806,745.74.

**Production process:** After AW&LF was nationalised, the division of the production department into two sections was continued. The former "Fenili" section was assigned to produce "Wine" and "Syrup", and the "Vitale" section dealt with the production of "Liquor" and "Aperitifs". The firm's production system is quite labour-intensive and each production section can only produce one type of product at a time. Its production processes are simple; they consist of mixing, fermenting, decanting and filling bottles. With respect to liquor, syrup and aperitifs, the

necessary ingredients have to be mixed and sheet-filtered. Whereas the production of wine requires about 23 days of fermentation, the other products can be produced within one hour.

*The firm's administration:* Before independence, AW&LF was administered under the 'beverage corporation of Ethiopia'<sup>19</sup>. After 1991, the firm was put under supervision of the MTI, like all other public enterprises. After privatisation, one particular group that gained a considerable influence were the shareholders. These shareholders are highly involved in the daily activities of the firm. The owners have put much effort in making the factory productive and profitable. They monitor the firm's affairs on a continuous basis and pay particular attention to market issues as well as finding timely solutions to market-related problems. By diversifying the current product lines, the owners want to expand the firm's market share as well as enhance its productivity, sales and profitability. To make maximum use of its limited resources and manpower, the firm's owners closely monitor the activities of each department. The shareholders also play a role in this. Their particular focus is on strengthening the control system and increasing the departments' performance.

## 6.2 General changes during the transition period [1999 up to the end of 2002]:

Like all potential bidders, the present owners of AW&LF conducted their own assessment to gain a broader insight into the strengths and weaknesses of the firm by mapping out possible opportunities and threats. In 1998 they presented their business and investment plans and offered to buy the firm from the government. Their business plan included, among other things, cost-effective rehabilitation programmes to revive the firm. The potential owners also indicated that they would investigate the local and export market opportunities and study the possibilities concerning the supply of raw materials. Further, appropriate technologies would be selected and a new plant layout drafted. Major objectives were to reorganise the firm, modernise its machinery, improve its overall efficiency and diversify its product line, for example, by introducing the production of fruit juice. The latter would require the construction of a new building. In addition, the employees would be offered training to improve the quality (mainly flavour) of the beverages. To promote export, sales agents would be appointed in various parts of the world.

The business plan indicated that the firm's machinery and production facilities dated from the 1940-s. So most of the machines were in a very poor state. The owners therefore made an inventory of the changes required in several areas, such as technology and hygiene. One of the tasks to be carried out was repairing and maintaining the existing wooden and cement tanks in the fermentation section, and to replace them eventually by fibreglass or stainless steel tanks.

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<sup>19</sup> The Beverage Corporation of Ethiopia is a central government body, located in Addis Ababa, which co-ordinates the activities of the beverage firms in the provinces, gives them directions and approves their budgets.

Filtration was still performed manually with the aid of cloth sheets and a machine. Also tasks such as filling, washing of the bottles, labelling and partial corking were carried out manually. All these tasks had to be automated, for the firm had hygiene as well as leakage problems. The plan proposed to automate the tasks performed by the liquor department. These tasks include filtering, filling, capsuling, and washing. In addition, tasks for the production of ginerino and aperitifs had to be upgraded, such as labelling, preparation mixer and the electrical corking machine, and filtering pump. Further, the production process of syrup products, requiring special care because of their sugary flavour, had to be improved.

As indicated in chapter 5, the owners were bound to the commitments as stipulated in the ‘Sale and Purchase Agreement’. This agreement stated that an insufficient implementation of the business plan would be a valid reason for a total revocation of the contract.

The firm significantly changed its organizational structure with respect to key managerial positions. In addition, target markets as well as raw material sources were selected, and capital investments were made. Further, training was offered to the employees, working schedules were adjusted and MCS practices re-assessed. In our analysis, we will address the firm’s policies in relation to MCS change and firm performance. In addition, we will integrate the influence of internal and external contextual factors.

### 6.2.1 Realisation of the business and investment plans:

In realising the business plan, the owners expected to receive support of the government. They expected that they would have sufficient access to raw materials and manpower. As we have seen in chapter five, however, the actual situation was quite different. As Mr. Alem indicated: *‘When preparing a plan, the conditions for executing it should be favourable. It is then relatively easy to forecast next year’s operations on the basis of the current developments in the firm, market, and the wider environment.’* The major problems faced by the companies were the shortage of manpower and the abolishment of forex services. They had not anticipated these developments, assuming that the government would fully support them in implementing their business and investment plans. This, of course, also applied to AW&LF.

**6.2.1.1 Organizational structure:** Like all public enterprises of the period, AW&LF consisted of three divisions that were directly accountable to the general management: Finance & Administration, Production & Technique, and Marketing. These divisions were again divided into departments and units, employing a large number of employees. In their business plan, the owners proposed to reduce the size of the administrative offices. So the Finance Department was reduced to only a few people, and the personnel of the main store was cut down to one employee. The firm has six owners, Mr. Rezene Tesfay (the general manager), Mr. Beyene Tsegay (production head), and Mr. Teclegergis Haile (head of commerce) and their respective spouses. The three gentlemen make up the Board of Directors, of which the general manager is

the chairman. Prior to being expelled from Ethiopia as a result of the border conflict, the owners were running their own individual businesses. They had their own truck repair garages and owned multi-storey apartments in Ethiopia. The three partners are graduates of a technical school. Mr. Rezene, who has a law degree, additionally practised as a lawyer. Although having an adequate technical background, the owners had no experience in running a firm such as AW&LF at the time of purchase, and neither did they possess any knowledge of accounting. They were; however, keen to learn about all issues involved in this business. The owners focussed on various activities, such as production planning, raw material purchases, marketing, monitoring and evaluation as well as decision-making. And of course they had to give their approval in all of the firm's decisions and financial matters.

Mr. Alem is a certified public accountant and the head of the Finance and Administration Department. He is the general manager's cousin. During the transition period the duties and responsibilities were divided similarly to the way in which they were assigned in the public ownership period. The difference is, however, that since privatisation the firm has no longer an internal auditor to verify the accuracy of records and documents and check the related authorisation. Since the transition period the commerce department has been in charge of the procurement activities and the supervision of the sales units. The firm consists of two stores, the central/main store and the finished goods store. The main store contains various types of stock, such as raw materials, labels, spare parts and chemicals, to be processed by the production department. The finished goods store contains the firm's finished products. In addition, there is a mini store resembling a kiosk, located next to the company's entrance. This mini store sells part of the firm's products by retail. During the public ownership period several employees were working in the main store under the supervision of the chief of store, who monitored and audited their daily activities. Nowadays, one employee is in charge of the entire store, which means that his workload has very much increased. This has caused considerable delays in the processing of information and the preparation of reports.

**6.2.1.2 Investments:** Mr. Misghenna, the vice production head, explained that the firm introduced numerous changes to eliminate the bottlenecks of the pre-privatisation period. The firm has repaired damaged machinery and purchased new equipment, such as refining, pressing and capsuling machines. In addition, two distribution trucks were bought. Ever since privatisation, the factory buildings have been in a process of refurbishment. Moreover, the production site has been considerably improved. In general, the owners' policies have been aimed at boosting sales. Some examples of annual investment figures are: 457,231 Nakfa in 1999, 15,000 Nakfa in 2001, 266,868 Nakfa in 2002 and 324,673 Nakfa in 2003. An analysis on the basis of capital expenditures to sales (CES) and capital expenditures to assets (CEA) shows that in the post-privatisation period the situation has improved (see table 6.1, p. 139). The investments made in the firm's machinery have been beneficial in the way that nowadays the

equipment can function flawlessly for at least a month. During public ownership this was not the case; even the production of one single batch often involved machinery problems.

Before privatisation the firm's storage facilities were poor. The containers were piled up outside, being exposed to the sun, rain and dust. This weakened the bottles, which is why many of them used to break during the washing process. To solve this problem, the firm constructed about seven storage places. Also the production area was in a poor condition and had to be renovated. Repair work included fixing the pipelines, the floor and the electric wires. Also the machinery was updated. All these improvements have stimulated the production growth. As already mentioned in the previous chapter, the abolishment of forex services was an issue. The firm's investment efforts, however, were successful in terms of leverage. Prior to its privatisation, the company was faced with an enormous debt. Table 6.1 shows that the total debt to asset ratio (DAR) was between 42 and 83 percent from 1993 up to 1997. After privatisation the DAR ratios significantly improved. They declined from 41.6 percent in 1999 to 14.4 percent in 2003, which shows that the firm is no longer heavily indebted.

**6.2.1.3 Employment, training and benefits:** During the 'Derg Administration' the firm had more than 100 employees. The purpose behind this large number of manpower was to decrease the national unemployment level. In 1996 the Government of Eritrea (GOE) reduced this amount to 47 (comprising 35 male and 12 female employees). This number remained stable until the privatisation process started. Two third of this workforce was engaged in service provision and one third worked in the production area. Table 6.1 shows that the workforce has decreased. In 1999 a policy was implemented to eliminate the redundancy of the workforce and to appoint people who were more qualified. The years 1999 and 2000, however, were turbulent, and the firm did not manage to increase its production. In 2001 AW&LF raised its production and sales levels and was in the position to hire additional people. Further progress was undermined, however, by the firm's obligations to the national service and the abolishment of the forex services.

Mr. Alem argued that during the public ownership period employees received fixed salaries (irrespective of their competence). After privatisation this changed. Now salaries are paid on the basis of the employee's skills and productivity. The firm maintained most of the employee benefits dating from the public ownership period. Every year the employees receive working overalls and rubber boots. Every working day, they are provided with tea and bread services at fixed hours. After privatisation, benefits such as medical services and bonuses were no longer maintained, but their introduction is again being considered in the *collective agreement*<sup>20</sup>. This

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<sup>20</sup> The *collective agreement* contains the agreements reached after negotiation between employers and employees concerning the latter's rights and duties, based on the country's labour laws. The collective agreement serves as an instrument to correctly implement the national labour law in enterprises. It is referred to when dealing with employer-employee disputes.

agreement has already been drafted, but the partners still have to negotiate on its exact contents before its final approval. Due to the country's frustrating business climate negotiations on benefits for employees have not yet taken place. One of the ideas is to establish a firm-based union. In general though, the treatment of employees is in accordance with the labour law; there is no intimidation or abuse of any sort. The TU people often visit the firms to check whether they provide medical care and other benefits. In addition, the establishment of separate base unions is propagated.

The interviews conducted with Mr. Rezene, Mr. Alem, Mr. Misghenna and Mr. Tewolde indicate that privatisation has changed employees' attitude towards their work. Their motivation to fulfil their obligations and maximise their performance has considerably improved. They are described as *'highly disciplined, duty-conscious, committed to their work, and willing to accept orders from their bosses. They have no complaints about the routine procedures of the factory, and neither about their salaries. The employees feel responsible for their jobs, unlike the majority of those who work in publicly owned firms. These employees care less about their jobs and simply count off the days until they are paid again.'* If an employee performs inadequately, a meeting is arranged to discuss the issue. Mr. Misghenna described the relationship between the firm and its employees as 'familial'. Twice a year the firm organises meetings for its employees. In addition, the Production Department holds quarterly meetings, and if required, even monthly. The interviewees all agreed that *'the employees' productivity and morale is good, and they support each other.'* There is no problem of absenteeism; only in the case of sickness or other serious problems do the employees stay at home.

To encourage and reward employees' good performance, regular salary increases formed a standard procedure in the firm's business policies from 1999 until the end of 2002. In the light of maximising job satisfaction, salary increments were regarded as part of the employees' benefits. For example, in 2002 no significant profits were made, nonetheless the shareholders decided to introduce salary improvements. In later years, however, profitability further declined, and it became problematic to sustain these benefits. The interviews indicate that the present level of salary is higher compared to that in the public ownership period. But the continuous rise in the costs of living makes it hard for the employees to make ends meet.

**Labour-related problems:** Due to the mandatory national service AW&LF lost about eleven employees, which had a negative effect on the firm's activities and performance. The firm's management asked the Ministry of Defence (MOD) to send a number of the employees back in return for their salaries. AW&LF in fact succeeded in getting back some employees under these arrangements, but their productivity declined below expectation. This was partly because they no longer received their salary directly from the firm, but were paid a lower salary by the MOD. AW&LF tried to increase their motivation by compensating them, but the firm did not succeed in getting back its liquor expert despite its persistent effort. Another poignant example of losing

employees to the military is illustrated by an event in which a sales agent was picked up from the street just before making a delivery. The distribution truck, still containing the whole supply, was left unattended for hours until the firm was finally notified. Similarly, the chief of the main store was taken from his home for the compulsory national service. He still had the keys to the main store at his home, which was collected later. AW&LF was forced to assign another to the stores to resume operations. Months later, the former store employee was released from the army because of health reasons. He was given a job at a governmental office, but the firm managed to get him back eventually. Because the salaries paid by the MOD were lower than those paid by the firm, the chief of stores was given an extra amount each month to be able to support his family.

Mr. Misghenna explained that the seven to eight employees that had left to join the national army were replaced by female employees and pensioners who had formerly worked with the firm. Data obtained from the MTI indicate that in 2000 the firm's female workforce was thirty-six percent; rising to forty-six percent in 2001 (see appendix-B). Also the shortage of manpower in the Commerce Department was solved by appointing retired former staff members. These employees were well-acquainted with the work but less productive than the younger staff. In sum, a combination of factors, including a lack of employees, governmental measures, rising costs of living and fierce competitive circumstances, affected the firm's performance in an unfavourable way. The labour problem could get even worse if the firm would be required to work at full capacity. Especially the female workforce posed a problem in that the factory work was heavy, requiring a great deal of physical strength. In order to improve its firm performance, the AW&LF was therefore clearly in need of young male employees.

Given the situation depicted above, the protection of the remaining workforce became one of the firm's major concerns. This was not easy, since some employees tended to take advantage of the circumstances by asking for a salary raise when another employee left to join the military. If the firm refused, it ran the risk of losing yet another employee. Those demanding a salary raise clearly had a strong case, since there were plenty of opportunities elsewhere. Mr. Rezene said: *'It is difficult to confront employees when they make mistakes or are inefficient. To some extent the prevailing situation motivates the employees to be disobedient to their bosses. The firm treats the employees well, just as one would treat a child, for fear of losing them.'*

**6.2.1.4 Product-market decisions:** The firm had four product lines and adopted two marketing strategies. The first strategy was aimed at ensuring a wide distribution of the firm's products throughout the country by opening up distribution centres and/or appointing sales agents at the administrative centres in the major cities. On the local market, AW&LF distributed its products directly to the wholesalers and retailers by employing sales agents and making use of its networks. Generally, privatisation changed the approach to marketing and the distribution of products. After privatisation, the firm's shareholders started to conduct extensive market studies



to acquire information regarding sales, market demand and customer behaviour. This information helped them in their goal to improve firm performance. In addition, together with the sales agents they regularly visited restaurants, bars or other establishments to advertise the firm's products and observe customers' reactions. During these visits they tried to convey the message that making quality products requires a certain price level.

Having three trucks improved the firm's product distribution. In addition, the number of sales agents was increased. In this way, more products could be distributed to a larger number of places, such as the city centre and the suburbs. The major factors improving the sales figures included a good service provision as well as the ability to keep appointments and to meet deadlines. In addition, the firm also delivered products to individual customers. It managed to improve both the quality and quantity of its products. Moreover, it put a great deal of effort in diversifying its assortment by introducing new products, such as champagne. Although this product is seasonal, its demand was high. Some test trials conducted by the firm showed that the customers liked it, and retailers managed to sell it at a price almost double to the amount they paid for it themselves. Next, the firm had to get access to forex to import the raw materials for its production.

The second strategy was establishing a network to stimulate export activities. This network was based on contacts with the local Chamber of Commerce and other trade associations within Africa. The firm's ultimate aim was to expand its business to overseas markets, such as those in countries of the Horn of Africa (Ethiopia and Sudan), Eastern and Southern Africa (Kenya, Uganda, Rwanda, the Democratic Republic of Congo) and the Middle East (Saudi Arabia and Yemen). In the light of these export objectives the owners planned to conduct a market assessment that would form the basis for the firm's marketing plan. Market assessments together with the renovation of the firm's machinery and a clear focus on product quality were important measures taken as a result of the privatisation process.

Because of their high demand, liquor products formed about 80% of the firm's production output. AW&LF's biggest competitor in this period was the Asmara Brewery Factory (ABF), a well-established public enterprise that had been in operation for a long time. ABF's market share was relatively larger than that of AW&LF, and it made use of the forex services provided by a government bank. It had its own distillery plant, and its production capacity was large. AW&LF, on the other hand, produced its liquor in small volumes. To be competitive, however, it was forced to adopt similar prices. So high input costs, a low production volume and difficulties in obtaining resources clearly undermined the firm's position in terms of competition. Mr. Rezene stated that *'in principle, AW&LF should set its liquor prices below those of the competitors in order to gain market share. But the circumstances as they are do not allow us to do that.'*

Another problem was formed by a new group of small liquor producers selling products at prices of two to three Nakfa less than those sold by the larger companies. According to Mr. Rezene these prices were not realistic in terms of production costs. He also had serious doubts about the quality of these products. He indicated that the price of the imported alcohol was fixed and that AW&LF sold its products at a minimum profit margin. He stated: *'Whatever efficiency levels competitors maintain, in the case of standard products costs can not differ so much. Therefore, it is odd that they are able to operate in this way. They could only sell them at such prices if they reduce the amount of alcohol.'* Mr. Alem added: *'Competition is mainly controlled by prices. The firm and the small competitors import their raw materials at the same prices. And on this basis we are all required to deliver products of acceptable quality. So if the competitors produce their products in smaller volumes than we do, they are not expected to offer them at cheaper prices.'* Despite these issues, interview responses indicate that some of the firm's unique products, such as gingerino, succeeded in competing with coke products.

Other factors contributing to the decline in sales of some AW&LF's products (liquor and wine) were the lack of export opportunities and the import of foreign beverages. Before privatisation, the firm's products were exported to neighbouring countries, such as Ethiopia and Sudan. These export transactions were conducted via businessmen who sold the products by illegal means. They collected the beverages from the local shops at standard market prices. These indirect exports stopped as a result of the border conflict between Eritrea and Ethiopia, causing a severe decline in demand. During the transition period export activities were no longer possible.

With regard to the import of beverages AW&LF's management hoped that the government would take measures to protect the local producers. Another measure required was the introduction of quality standards. As Mr. Rezene had heard from some restaurant owners, foreign customers often ordered local wine with their meals, whereas the local people ordered the expensive imported wines. But when asked whether they had ever tasted the local beverages, the answer was in most cases 'no'. It appeared that drinking imported wine was generally considered as a sign of prestige and status. So the notion that *'imported beverages are of better quality than the locally made liquors'* was mainly a commonly shared prejudice. Mr. Rezene was given a tip by an owner of a local tissue manufacturing plant how to become successful on the local market. This owner had decided to remove his firm's brand name from the label. Instead he used four different brand names. As a result, his sales had risen dramatically. The owner suggested AW&LF should do the same. Apparently, the local people were not appreciative of indigenous products. The firm's incessant market efforts, however, made a significant amount of clients see that it delivered products of better quality than those of the small competitors.

Particularly in this line of business, success depends on the quality of the product. As Mr. Rezene indicated: *'Quality should be a thing that the organization can openly advertise with*

*and count on.*' This required a great deal of the firm's efforts with respect to upgrading its machinery and training its manpower, which was a time-consuming process. Moreover, it was forbidden to advertise the quality improvements, which made it difficult to reach clients. They actually had to taste the wine to realise how good it was. In this way, the firm's sales promotion strategy was seriously undermined. Despite all these problems, however, the firm managed to expand its market. The Commerce Department conducted market surveys on a regular basis and made variance analyses each quarter to acquire knowledge on how the products were performing in the market. If significant differences occurred between the planned and actual sales, these were investigated. In general, sales were affected by the lack of forex, unfair competition, the prohibition to advertise, consumer behaviour, and a shortage of bottles.

**6.2.1.5 Sources of raw materials:** The raw materials required by the firm include raisins, sugar, chemicals, essences, colour, alcohol, bottles, capsules, water, filters, corks and crown corks. During the public ownership period, the alcohol and crown corks were locally obtained from ABF. The bottles were obtained from the Denden Glass Factory, and the remaining materials were imported from countries like Turkey, Italy, Greece, Belgium and Spain. In the transition period, there was no guarantee of getting the alcohol and crown corks. Other raw materials were also hard to come by or not available at all. For example, in 1995 the glass factory was shut down and the government did not invest in a new one, as it had promised. Although AW&LF managed to continue its production and did not have to import bottles, the shortage sometimes caused delays in production due to the fact that the firm was dependent on the refillable bottles collected from its clients. The run for bottles increased by the emergence of small local competitors. To avoid production interruptions, the Sales Department spent a great deal of time on collecting empty bottles from clients.

The firm had to import its alcohol because that of ABF was too expensive. With respect to various issues, AW&LF relied heavily on import during this period. In 1999, however, an interesting development took place. Some local farmers started growing grapes at a small scale, particularly in the vicinities of Elabered and Decamere. It would, of course, be of enormous value if input sources could be obtained locally. Therefore it was of great importance that initiatives, such as growing grapes and sugar cane for wine as well as citrus fruits for fruit juice, were stimulated. The import of resources still continued, though, with the aid of forex from the black market. Alcohol and bottles were the items on which the highest amounts of forex were spent. Mr. Rezene expected the MTI to undertake action to solve the problems of the beverage industry, at least with respect to the availability of alcohol and bottles. Main issues were the forex problems and the high level of production costs, which will be addressed later.

**6.2.1.6 Changes in working hours:** During the transition period the shareholders proposed to change the employees' working schedule. The new schedule introduced a one-hour lunch break each day as well as a 10 to 15 minutes morning break during which free tea and bread were

served. The working schedule was as follows: from Monday to Friday from 8:30 until 17:30 hours, and on Saturday from 7:30 until 13:00 hours. The new work schedule meets requirements of the labour laws and was supported by employees.

## 6.2.2 Changes in MCS practices, firm activities and performance in relation to the influence of internal and external factors:

**6.2.2.1 Planning and Budgeting:** During the public ownership period, AW&LF prepared annual budgets consisting of the reports of each department. Sales were forecasted first, forming the basis for the production budget. The production volume was set at five percent above the expected sales volume. Before being compiled into one report, the departmental budgets were always first discussed internally by the production head, the sales head, the purchase unit, the finance administrator and the management. After that, the final document was sent to the MTI for approval and defended by a representative of the firm at a meeting organised by the Beverage Corporation. It was usually not difficult to get approval for the budget, as long as the targets were set higher than those of the previous period. When the budgets were approved of, monthly and quarterly overviews were made of the figures resulting in schedules that were executed on a day-to-day basis. Any deviations were generally due to water shortages, power failure, downtime, absenteeism of employees, etc. The achievement of targets was usually rewarded with bonuses, salary increments or prizes. During regular meetings the employees were kept informed about developments with respect to issues such as budgets and performance. After privatisation, however, the firm stopped following these procedures. Budgeting practices were merely performed loosely at top level. The firm mainly let its budgeting policies depend on factors such as competition, the availability of empty bottles, hard currency, etc.

Mr. Misghenna indicated that *'The factory should apply budgeting practices and ensure the equal participation of the departments. This would stimulate guidance and performance measurement, and improve the structure of the resource consumption plan. At the moment, the factory benefits from the knowledge of the expected output provided by a given production batch. This knowledge helps predict the necessary input of raw material ingredients, manpower, empty bottles, production time, and the expected output of each batch. This input-output relationship is used as a means of planning and controlling the factory's resource consumption.'* With respect to planning, Mr. Rezene explained that the Sales Department prepared the annual sales forecast, to be discussed in the shareholders meeting. If the plan contained issues that the members of the meeting did not entirely approve of, adjustments were made. The forecast was, however, treated as a best estimate from which the actual sales figures tended to deviate. This approach clearly differed from the one adopted during the public ownership period.

During the transition period, the MTI ordered all firms to prepare a five-year business plan. This plan had to include estimates regarding sales, production, the requirement of raw materials and manpower as well as a strategy to enhance the firm's profitability. In addition, firms were required to conduct assessments of the size of manpower and inputs on a regular basis. AW&LF's main focus was to capitalise on labour efficiency, productivity and waste minimisation. In realising these objectives it was difficult to avoid the impact of external factors, such as the lack of forex, which prevented the firm from importing a sufficient amount of raw materials.

AW&LF introduced some changes with respect to its planning and control. For example, the firm's management made its purchase decisions on the basis of a monthly stock status reports that included priority lists indicating how the materials should be ordered. Then, the finance head together with the shareholders determined when to place the purchase orders. To prevent production disruptions due to shortages and delivery delays they mainly based this decision on the delivery lead-time. With respect to increasing its profits, the firm put a great deal of effort into promotion activities. In addition, achieving customer satisfaction was an important issue. In view of the firm's growth strategy these were major objectives. Another point of interest was making optimal use of the scarce hard currency. During the public ownership period the chief of the main store did not feel the responsibility to follow-up purchase requisitions. After privatisation, the shareholders were the ones deciding upon the orders on the basis of the monthly stock status reports. When deciding upon the orders, attention was particularly paid to making sure that the amounts would correspond with the capacity of the containers. In this way costs could be saved. In this respect, Mr. Tewolde remarked that *'the present control system is fast and effective.'* So after privatisation the firm managed to improve its planning procedures considerably. There were, nevertheless, still other factors that hindered the firm's planning process, such as the lack of forex, fluctuations in the prices of materials, and finding optimal sources of supply.

Before Eritrea's independence, the import of raw materials involved opening a letter of credit (L/C). First, a team comprising people from Purchase, Production, Technique, Accounts, and the stores made a selection of potential suppliers and sent the resulting list plus some recommendations to the MTI. The MTI usually took two or more weeks to study the matter. In order to get feedback more quickly it was therefore common practice to make some phone calls or have people visit the MTI. The MTI was entitled to make adjustments to the size of the order or ask firms to look for additional sources of supply in order to save forex costs. Only after this procedure was carried out did the MTI approve of the purchase order, and could the formal contacts with the supplier commence. Due to the considerable time period required for this procedure, the production processes were often interrupted because the firms were short on raw materials. Thanks to privatisation these bureaucratic hurdles were eliminated. The shareholders were now the ones who financed the import of the raw materials through their own means. They

decided on how to acquire forex and determined the size of the orders. Like IMA, AW&LF was dependent on the parallel market to obtain forex.

The inspection of the incoming raw materials was carried out by the head of the main store. This labour-intensive task was performed by a number of people during the public ownership period. The firm adopted all procedures with respect to the ordering, issuing and recording of raw materials from this period. Generally, the resources were ordered for one week at a time, but the firm's management preferred daily deliveries for control reasons and because it wanted to avoid creating a 'mini store' inside the production department. The firm therefore planned to construct a small storage place next to the production area. In this way materials could be ordered per week and the paper work involved could be reduced.

The firm kept records of the standard quantities of the raw materials required, such as alcohol, colour, and essences for a given output level. In this way the resource consumption could be estimated, making it easier to plan the production process. Although AW&LF's production capacity was adequate at the time, an increase in demand would cause problems due to the capacity limitations of machinery and the shortages of bottles. This is why the firm made sure it had an extra stock to meet any unforeseen demand. In the case of wine this was actually a necessity because its production takes twenty-five to thirty-five days, whereas liquor can be produced within a day.

During the public ownership period, the annual production targets were fixed. After privatisation, they were based on demand, and the planning and budgeting activities were co-ordinated at top level. The production plan was now prepared by the production head in consultation with the shareholders. It includes the amount of products for a product line and the time required to finish its production. The production department kept track of the production process on the basis of the daily and weekly reports of the finished goods store. In this way product-mix adjustments could be made in the meantime if required; the stock of fast-selling products could be replenished, whereas the production of other items could be reduced. At times, priority was given to seasonal products (e.g. the production of syrup during the period of Muslim fasting).

#### ***6.2.2.2 Product Costing and Pricing***

***Product Costing:*** During the public ownership period, the firm's accounting practices were based on a manual prepared by the MTI. Its Finance Department had a separate costing unit, which applied absorption costing. This method focuses on the standard costs of materials, labour and overhead. At the end of each fiscal year these were reconciled against actual costs. The overhead costs (OH) were classified per department and the operating expenses were kept separate. After privatisation the costing unit was abolished. The costs were, however, still classified and accumulated per department. Actual costs were used for materials and direct

labour, which were revised every quarter. The overhead costs were based on a predetermined rate. This aggregate figure was then allocated to products on the basis of output (i.e. total OH divided by total output in litres). The firm preferred the OH allocation system because of its simplicity. It is, however, not completely accurate. So the firm dealt with cost calculation in more or less the same way as the publicly owned firms. The main difference was that the depreciation expenses of office buildings were included into the manufacturing costs. This was because the administrative offices were located at the first floor right above the production area. This practice, however, decreased the accuracy of cost information.

In addition, the accuracy of the material cost records was affected by a government policy that converted the value of imported goods to the local currency through the use of official rates when charging customs. Such a policy undermines the cost principle, resulting in loss on exchange (as the difference between actual cash paid to acquire forex and the equivalent value at the official rate is not treated as an expense). When calculating the manufacturing costs for internal use, however, the firm always recognised the actual costs of the materials. Mr. Tewolde indicated: *'It is illogical and improper to ignore the actual costs, although the government does not want to accept this.'* The firm was forced to pay tax on the difference in value (i.e. loss on exchange). So if loss on exchange is not included in the manufacturing costs, it artificially reduces them, raises taxes and affects profits. IMA also faced this problem.

**Product pricing:** Of the four product lines liquor was the most competitive one in the local market. Although during the transition period AW&LF was the sole local producer of wine, there were also a few imported brands that had gained some market share. The firm was also the only local producer of syrups and aperitifs, but sales of these products were affected by products such as soft drinks and mineral water. Therefore, the firm was not free to set any price it wanted. Mr. Alem said: *'The only option left to us to enhance returns is by capitalising on customer satisfaction and promotional activities. This requires adjusting our prices to those of the substitute products, since it is impossible to improve our profitability by charging higher prices. As a result, the factory is a 'price taker', and hence, product cost information plays a limited role in product pricing.'*

The demand for AW&LF's products was high in this period, and they were usually sold directly after their production. It was especially high in the case of weddings and during religious holidays (such as 'Nigdet'). For the rest, the firm focussed on customer satisfaction to keep its business profitable. To achieve this it offered its products at competitive prices. Mr. Alem explained that *'The liquor product line is mostly threatened by both the actions of small entrants on the market and customer behaviour. The small competitors sell the liquors cheaper and are spoiling the market. The present economic situation has also decreased the purchasing capacity of consumers. In addition, products like ginerino are seasonal. These factors have negatively affected our revenues. In our culture people mostly prefer to buy liquor as a present for special*

*occasions (religious, family, or social). Customers are generally price-sensitive and do not care about the type of brand they buy, as long as the products are similar. This makes competition very tough.'*

He added: *'The competition of the liquor line is not fair and thus every competitor should abide by the policies and guidelines to make it fair. The current competitor prices do not cover our total costs. There are means to engage in unlawful business to avoid taxes, such as avoiding formal bills when purchasing raw materials and selling products. However, AW&LF does not wish to indulge in such practices and thus cannot reduce its liquor price to match that of the competitors. Adopting the competitors' prices might involve making compromises in quality. But no matter what, the factory is determined to maintain its quality standards.'*

**6.2.2.3 Internal Reporting and Decision-making:** After privatisation, the shareholders were keen to adopt measures of record-keeping. They encouraged the employees to use the forms and procedures handed to them in an effective manner. Mr. Tewolde stated: *'The owners have facilitated the recording and reporting processes in the departments, which is encouraging. It makes them different from other private investors.'*

The owners put much effort in ensuring that the internal reporting procedures were carried out smoothly. The firm adopted all internal control means used in the public ownership period, such as store requisition, store issue vouchers, production transfer form, and production receiving note. The Finance Department checked its stock records regularly with those of the main store. Further, the firm planned to introduce separate store issue vouchers (SIVs) for raw materials, stationary and other input items instead of using a single one for all items. In this way, movement of the goods could be monitored in more detail. The firm decided, however, to wait with this measure until the former forms had been used up. The Finance department also conducted periodic stock reconciliations in order to match its records with the main store.

The factory conducted daily, weekly and monthly sales reports. All internal forms and reports were used in conducting monthly analysis and necessary actions were taken to investigate and correct significant variances. Focus of the monthly analysis was on sales trend, productivity, and input levels. Results of actual activities were compared with that of previous periods in order to get better insight. Product line performance evaluations were also conducted with the help of the daily, weekly and monthly stock movements and inventory level reports that were generated by the finished goods store. The reports include information about quantity of finished products received, those transferred to sales trucks and the return of daily unsold items. Mr. Tewolde explained that the main store and the finished goods store still use adopted forms. He claimed that *'the system in place is well organised and no improvements are needed.'*



Each department had its own specific activities and procedures. The Production Department accounted for the raw materials usage by means of consumption reports and for the empty bottles by filling in finished goods transfer forms. Bottle breakage was also recorded. Mr. Misghenna indicated that: *'Thanks to our effective control system there is nothing that remains hidden in the Production Department.'* The Commerce Department sent duplicates of the sales invoices and daily sales reports to the Finance Department. Unsold products were returned to the finished goods store at the end of the day, and registered on the 'products return form'. In addition, the Ministry of Finance introduced a regulation stipulating that firms issue sales receipts instead of recording them on client's records. This was, however, a time-consuming procedure for the Sales Department.

The products were sold on cash basis, and the empty bottles were always returned to the factory. Records of the sales agents' activities were sent to the Finance Department every day. Any anomalies were immediately investigated. The cash resulting from the daily sales plus deposit of containers was handed over to the firm's cashier in exchange for an invoice. Similar procedures applied to the mini store. Control was exercised, however, once a week rather than each day. The weekly balance of unsold products was determined by counting them physically. At the end of each month the unsold items were returned from the mini store to the finished goods store to facilitate monthly physical counts.

The Department of Finance prepared monthly reports, one dealing with *'product sales and deposits payable income'* and the other with *'bottles and container deposits'*. The sales report was classified by product lines. At the end of each quarter and at year ends, the information of both reports was aggregated. In addition, an annual graphic report on the actual production volume plus information regarding the amount of the actual sales revenue (the total figures as well as a specification into product types) was presented to the firm's management. These types of reports were introduced after privatisation and served as guidelines for the shareholders, who discussed them in their meetings. In the public ownership period, firms were obliged to send their monthly reports to the MTI. These reports also dealt with issues such as production, sales and purchases, but the MTI did not use them for evaluation purposes. The information in these reports was merely used for the MTI's annual statistical overview of firm performance. After privatisation, firms were still ordered to provide the MTI with information, which had to be filled in on pre-designed forms.

After privatisation, the quality control section performed various tests on the products. This section also prepared daily reports, which were sent to the general manager. The quality control section co-operated closely with the Production Department. In the case of change in product taste, usually due to the inferior quality of essences or flavours, management was informed and advised to consider a change of suppliers. The management also received sales reports on a weekly basis. Mr. Rezene said: *'In principle I prefer to collect daily sales reports. However, due*

*to practical problems the sales agents are not able to do this. We conduct door-to-door sales, delivering the goods with our trucks. Sometimes clients ask our salesmen to come back another day to collect the cash. So it would be unreasonable to demand daily reports when the collecting of cash is deferred.*' The Finance Department informed management about materials, containers, finished goods, disbursements and cash collections. Sometimes the finance head shared relevant information with management informally. After privatisation a number of internal reports were abandoned. These were down time, monthly raw material consumption and daily production reports, which were replaced by production transfer forms.

**Decision-making:** During the public ownership period, firms' main decision-making bodies were their management committees. In addition, the MTI as well as government regulations, such as hiring and firing policies and salary scaling, played a dominant role. After privatisation the Board of Directors became the highest decision-making entity. It had a considerable amount of freedom with respect to issues such as salary scaling and hiring and firing policies. In addition, the shareholders had an active role. They could take action whenever required and make quick decisions. Especially, the general manager did not have to consult the shareholders whenever immediate action was needed. Each party, however, was always being kept up-to-date on all relevant matters.

Decisions leading to improvements in productivity, product quality, market share and competitiveness were generally stimulated. The firm's management encouraged the departments in undertaking fast action to facilitate their operations. For example, if a department was of the opinion that for competitive purposes the quality of a product could be enhanced by adding more ingredients to it, the request to purchase additional resources was directly approved of by management. The shareholders were also actively involved in looking for opportunities to yield better results. However, the government prohibited firms to advertise their products. All in all, there was a high degree of flexibility in decision-making, resulting from the involvement of the owners in the day-to-day activities of the firm. Decisions could be made much faster than during the public ownership period, because the level of bureaucracy had been significantly reduced. During this period making a decision about selling redundant resources took so long that they had long perished by the time the decision was being approved of. After privatisation, this was no longer the case.

Another difference was that with respect to matters that did not affect the firm as a whole the lower managerial levels also had some decision-making authority. This concerned issues such as, for example, the schedule for cleaning the production floor. Matters such as costs and profitability, however, were dealt with at the top level. The lower employees were entitled, though, to express their opinions as well as to supply management with information on issues that were of major importance to the firm. In the light of saving costs effectively and successfully, the owners required as much data as they could possibly get, and all information

(both internal and external) was welcome. This information covered various areas, such as salary payment, inputs, alternative sources of supply, appointing agents, and forex. As already mentioned, after privatisation quality care and the firm's image became major focal points, which had been non-existent during the public-ownership period.

Mr. Tewolde clarified that *'There was no serious sense of responsibility during public ownership. Employees were negligent and could not be bothered to keep accurate records. They did not care that materials perished in the store. What they considered important was keeping the materials in the store regardless of the state they were in. At present, control is exercised on a daily basis and negligence is not tolerated. The factory takes appropriate action before the stored materials have a chance to perish. The physical presence of the shareholders also plays a significant role in making people conscious about their duties and responsibilities. If one of the shareholders is absent, the other two can take his place, and everything remains in control.'* A clear advantage of privatisation is that shareholders take a real interest in strengthening the position of firms. One way of doing this is closely monitoring the actions of the competitors. Mr. Tewolde called this a key element, which was not considered relevant during the public ownership period.

**6.2.2.4 Cost Control and Waste Minimisation:** Prior to privatisation, public firms suffered from idle labour and low concern for performance. Thus the GOE retrenched the redundant manpower. Even after privatisation, the factory retained the most qualified and productive employees in order to improve its efficiency. Labour costs were controlled by keeping the workforce small but effective by means of job assignment plans. As a result, a significant increase in productivity was achieved (see table 6.1). There were, however, external constraints that impeded productivity, such as the lack of forex, inflation, government regulations and the shortage of young workers due to the compulsory national service.

Overhead costs included the expenses incurred by the facilitation of operations and the depreciation of machinery and buildings. It appeared that as a result of the external factors the firm was not able to fully use its capacity. It tried, however, to exercise control over its materials and resources consumption as efficiently as possible by means of internal documents. In this way, knowledge could be obtained of the standard input requirements as well as of the relationship between input and output. In the case of inefficiencies, the Finance Department informed the Production Department.

Prior to purchasing its raw materials, the firm always checked their brand, quality, transportation costs and input prices, the latter of which was directly influenced by inflation and the rates of forex that undermined the firm's profits. In dealing with this problem, AW&LF selected reasonably priced raw materials of adequate quality (not necessarily top quality). In this way, a balance could be obtained between quality and competitive prices. To further improve the firm's

general efficiency the shelving system of the main store was renewed, facilitating the monitoring of the inventory. The firm's management requested every department to offer suggestions regarding the further improvement of its control systems. Measures were introduced for monitoring the amount of bottles required as well as bottle breakages. Hence, the above stated issues were not given much consideration during public ownership period.

The production of beverages does not involve large amounts of waste. A batch of wine can easily be reprocessed if necessary. So the problem of waste did not really apply to AW&LF. The employees were specifically instructed to be careful during the process of filling the bottles. An issue more relevant to the firm was maintaining the quality standards of the beverages. A decrease in quality is directly related to the use of fewer ingredients. For this reason it is crucial not to economise on raw materials, which of course involves costs. In maintaining the product quality, Ms. Asefash, the firm's chemist, worked closely together with the Production Department, and a great deal of attention was being paid to the beverages' mixing process. In addition, the government's central laboratory regularly made biological analyses of raw material as well as of beverage samples. On the basis of these samples the firm acquired a certificate of good quality. The firm also planned to replace its old lab-equipment and instruments.

Mr. Alem said: *'It is quite clear that any quality problem (in the beverage industry) directly affects the health of clients. Therefore, strict product quality control is desirable.'* Sometimes, however, there were complications. For example, during the public ownership period the firm imported processed sugar especially prepared for making beverages. Due to the forex issue and the high price of the sugar, the firm could no longer obtain this resource. In order to stay in business it therefore decided to temporarily acquire normal sugar on the local market.

Another factor affecting product quality was the condition of the tap water. It was sometimes muddy and unclean. Although this did not pose health risks, it changed the colour of the beverages, which was undesirable. Further, a special point of interest was filling up the bottles properly. The firm paid much attention to this task, making sure that the standards were met. It had replaced the old manual capsuling machine, which damaged the crown corks, with an electrical one. Now, only some leakage occurred during the filling process of the aperitif line, but this was just a minor inconvenience.

**6.2.2.5 Performance Measurement and Evaluation:** During the public ownership period firms were allowed to include overtime work in their planning schedules, provided that the MTI approved of the budgetary arguments for this measure. After independence, however, this was no longer the case. The GOE prohibited the scheduling of overtime work, and budgeting and reporting procedures became mere formalities without a real function. Moreover, the MTI did not provide firms with any feedback on their reports, neither on their interim nor on their year end reports.

AW&LF had adequate procedures for monitoring its manpower and production as well as its business processes. Productivity was assessed on a daily, weekly, monthly and annual basis. Sufficient information about input requirements and expected outputs were available on all product lines. In addition, the inventory of the main store was annually checked and its condition was assessed by a group consisting of the management together with the heads of Sale, Production, and Finance. Before privatisation, the labour productivity was between 39,500 and 96,600 Nakfa per employee (see table 6.1). After privatisation, this increased up to figures between 58,500 and 123,100 Nakfa per employee. From 1998 until 2001 the growth rate continued, but after that productivity started to decline. Also in the case of AW&LF this was mainly due to external factors. Quite frequently it happened that there were no empty bottles, which caused delivery delays. In turn these delays affected the production and sales schedules and undermined the firm's profitability. The bottle shortage issue became even more problematic when small local competitors entered the market. Furthermore, there were often delays in the distribution of the bottle labels, and there was a shortage of crown corks. On top of this, the forex situation, as already referred to, made the circumstances even more difficult. It is obvious that dealing with delays was one of AW&LF's main problems.

Also the firm's sales performance was evaluated by means of daily, weekly, monthly and annual reports. The focus was on trend analyses, concluded each year with an annual variance assessment. The objective was to achieve a match between production and sales. Mr. Alem said: *'When production dominates sales, or vice versa, it shows in the inventory. And of course it shows in the records.'* In the case of anomalies, the department concerned was expected to investigate. For example, decreasing sales figures may be due to a decreased product quality, high prices, or inefficiency of the salesmen. Approaching clients to receive feedback usually formed part of the factory's investigation. Further, the investigation included market surveys and departmental meetings in which the firm's performance standards were discussed. Another control measure included monthly shareholders meetings and informal contacts. Here, the shareholders evaluated the firm's performance, formulated guidelines and instructions, and usually exchanged information among one another.

Besides the above-mentioned reports, the firm's management also received quarterly analyses, such as financial statements, sales and production overviews and profitability reports. Mr. Rezene indicated that most of the time these reports were delayed by one or two months due to the shortage of qualified accounting personnel. The loss of staff was a result of the compulsory national service. The new employees, however, lacked sufficient experience and needed quite some time to get used to the systems. So the firm did not possess the amount of accounting information it actually required. This is why management clearly expressed the need for a full-time staff as head of the Finance department. Mr. Alem is working as a part-time staff.

Prior to the liberation, AW&LF made internal records of its production efficiency, productivity per man-hour, and down time. After privatisation other methods were introduced. As Mr. Alem explained: *'The production process is labour-intensive and often fluctuates, and so it is difficult to set hourly productivity standards. For many reasons people are not expected to maintain the same level of efficiency all the time, such as machines. But if the actual output drops below acceptable standards, the deviations are no longer tolerated. If the output declines, the batch group responsible is held accountable and has to give an explanation (e.g. output variations may occur due to leakage, bottle breakages, etc.). Control is exercised every day. The employees count their output items and report on variations, before the responsible section heads complete the output control procedure. In general, employees are open in telling about the errors they have made, asking assistance when needed.'*

Despite the difficulties the firm tried its best to improve its productivity, maintain its product quality, and enhance its sales. Every now and then, people from the MTI came to check the standard to the firm's products. It was important to AW&LF to at least maintain its current operations. What made this difficult was, however, that the prices of raw materials, labour, power and fuel was increasing, whereas the firm could not increase its product prices. In addition, the competition was severe. Further, the firm was not able to produce at a maximum level due to the forex issue, the shortage of raw materials as well as bottles, and inflation. This situation required the firm to turn to non-financial information, in the form of feedback by clients. In addition, the shareholders conducted market surveys to obtain information regarding the demand side. Often the heads of the Production and Sales departments visited bars or restaurants, and pretended they were customers. They ordered their own products and asked the opinion of clients about the firm's beverages compared to those of other distributors. They also obtained information on the beverages' peak sale periods. To stimulate sales, the firm offered clients' credit facilities as well as free delivery services.

**Financial analysis:** During this period the firm's use of financial performance measures was limited to annual reports. In addition, the owners conducted various studies to acquire knowledge with respect to obtaining bank loans and ways of utilising idle cash. Table 6.1 shows the developments of AW&LF's firm performance. After privatisation until the end of 2001 the firm was profitable. Its net earnings after tax increased steadily. In 2002, however, they started to decline, decreasing to a net loss before tax in 2003. The same trend applies to the sales figures. From 1993 onwards, sales grew steadily until the end of 1997, and again in the post-privatisation period from 1999 until the end of 2001. In 2001 the firm achieved its highest sales figures. As Mr. Fekadu explained, this had several reasons. First, the firm had invested in its machinery. Second, it had become more experienced in conducting its business efficiently and effectively, resulting in a better access to the market. And third, in 2001 enterprises could still profit from the forex services provided by the government banks. After 2001, these services

were abolished and inflation rose, which negatively affected firms' productivity and profitability.

AW&LF's believed that profitability depends on turnover. This is why it focussed particularly on the production of competitive goods. In addition, attention was being paid to stimulating customer demand and establishing good relationships with clients. To obtain an insight into the firm's profitability during the transition period, we calculated return on sales (ROS), return on assets (ROA) and return on equity (ROE). The results show that all three ratios were clearly lower than those in the public ownership period. The only exception was the ROS percentage in 2001 (based on net income). These figures can be explained by the increase in small local competitors and the rise in manufacturing costs, as reflected in the gross profit ratio (GPR)<sup>21</sup>. GPR was 43 to 55% during the public ownership period, whereas after privatisation it declined to rates between 17 to 41%. During public ownership ROA amounted from 9.42 to 26.65% per Nakfa of the investments made, whereas after privatisation it dropped between 1.18 to 11.99% per Nakfa. These differences are partly linked to significant variations in asset value. In the period from 1993 to 1997 the total asset value ranged from 2.26 to 4.53 million Nakfa. After privatisation it increased enormously to figures ranging from 14.04 to 17.54 million Nakfa, due to investments. Comparative financial statements presented in appendix-b give details on asset breakdown. With respect to ROE, prior to privatisation the ratios were higher than 28%, whereas after privatisation the maximum ratio was 16.5%. This can be explained by the fact that during the public ownership period the total capital was less than 2.08 million Nakfa, whereas after privatisation it increased to more than 9.67 million Nakfa (see Appendix-B).

Results on operating efficiency, output, and tax are as follows. The firm's *sales efficiency* improved considerably after privatisation, with the year 2003 as exception. Already before privatisation AW&LF's sales figures had started to increase until the end of 1996, but decreased again slightly in 1997. Net income efficiency has increased from 4,500 Nakfa in 1993 to 24,800 Nakfa in 1997. After privatisation the *net income efficiency* was 4,400 Nakfa (1999), but it increased significantly in the years after that, reaching its highest level in 2001 with 26,770 Nakfa. In 2002 it declined to 4,800 Nakfa. In 2003, however, the firm reported a net loss, which obviously had implications for the income figures. The decline in net income was associated with a decrease in sales revenue and rising costs due to inflation. Prior to privatisation, the firm's *output performance* was poor, with the exception of 1996, during which it was 6% higher than in 1997, the base year. In 1999 its output dropped to 72%, but after that it increased again, reaching its highest level in 2001 (117%). In 2002 it dropped to 84% and further declined to 51% in 2003.

The firm paid several taxes, such as excise tax, sales tax, personal income tax, profit tax, and municipality tax. Sur tax is meant for unexpected events such as draught or war. Sur tax is a flat

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<sup>21</sup> Gross Profit Ratio (GPR) = Gross Profit ÷ Sales.

rate tax charged on the amount of gross revenue. The firm paid this kind of tax during the period 1999-2000. Excise tax is related to the production of specific local products and imported materials. It is based on a firm's production costs and not dependent on sales. This type of tax stimulates inflation. The firm's management indicated that the taxes the firm paid had increased since privatisation. Appendix-b shows that the percentage of total annual taxes paid by the firm ranged from 34 to 41% of sales revenues. This was a significant amount, which demonstrated that AW&LF made a positive contribution to the country's economy. The shareholders, however, complained that the beverage industry was forced to pay a larger amount of tax than other industries.

The discussions in this section displayed that the nature of MCS at AW&LF can be classified as a mixture of diagnostic and belief systems on the basis of the classification of Simons (1995). We have observed that the factory did not prepare formal budgets, but short-term production plans were exercised. The concept of standard costing was utilised to measure resource consumption, to monitor production, and for reducing costs and wastages. The physical involvement of the owners, informal contacts among them, plus use of direct supervision had reduced the need for some internal reports. Thus, the amount of paper work has been effectively reduced relative to its current size. Also, decision-making has become very fast. At present, MCS has become more cost effective and efficient. Another feature of the MCS practice was the emergence of family type controls that gave some emphasis to personal relationships and trust among the shareholders. Further, the factory has registered success in its strategy on quality and customer focus on top of efficiency gains. The employees have become cognisant of costs and quality and this indicates an aspect of a belief system in the current MCS system of the factory.



## Post-privatisation changes in management control, firm activities and performance

**Table 6.1** Firm performance of Asmara Wine and Liquor Factory [AW&LF] during the pre- and post-privatisation periods (1993-2003)

Measures		1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Profitability	Sales Trend	100%*	133.17	174.38	244.77	239.59	N.A.	192.43	306.32	411.79	359.12	272.50
	ROS <sub>1</sub> (%)	43.20	47.59	54.56	49.78	53.62	N.A.	33.85	40.83	38.96	23.85	17.49
	ROS <sub>2</sub> (%)	11.49	18.27	26.17	25.69	27.19	N.A.	5.47	10.01	27.25	5.35	(8.69)
	ROA (%)	9.42	16.23	22.18	26.60	26.65	N.A.	1.18	3.24	11.99	2.33	(3.13)
	ROE (%)	55.91	28.22	40.75	70.54	64.05	N.A.	2.02	5.54	16.48	2.85	(3.65)
Labour Productivity	Revenue per employee	39,447	52,532	68,787	96,553	91,016	N.A.	81,686	120,745	123,087	90,266	58,491
Operating efficiency	Sales	39,447	52,532	68,787	96,553	91,016	N.A.	80,823	119,194	98,226	90,086	58,479
	Net income	4,532	9,596	18,000	24,809	24,752	N.A.	4,417	11,933	26,770	4,818	N.A.
Output	Trend (%)	43.34	57.72	75.58	106.08	100*	N.A.	71.80	100.31	117.11	84.24	50.58
Employment	Trend (%)	N.A.	N.A.	N.A.	N.A.	100*	100	81	77	109	85	79
Leverage	DAR	83.15	42.50	45.57	62.29	58.39	N.A.	41.60	41.50	27.27	18.16	14.36
	LTDAR	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	29.65	15.10	N.A.	N.A.	N.A.
	LTDER	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	50.77	25.81	N.A.	N.A.	N.A.
Capital investment	CES	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	12.82	N.A.	0.20	4.01	6.43
	CEA	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	2.76	N.A.	0.09	1.75	2.31
Tax	TPUS	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	38.57	41.06	39.40	34.97	34.16

Notes:

ROS<sub>1</sub>= return on sales [based on operating income figures], ROS<sub>2</sub>= return on sales [based on net income figures], ROA= return on assets, ROE= return on equity, Real Sales= Nominal Sales ÷ Consumer price index, DAR= debt to asset ratio, LTDAR= long-term debt to asset ratio, LTDER= long-term debt to equity ratio, CES= capital expenditure to sales, CEA= capital expenditure to assets, TPUS= tax per unit of sales.

\* 1993 functioned as the base year for sales trends.

\* 1997 functioned as the base year for computing output and employment trends.

The type of currency used in connection with labour productivity and operating efficiency is the Eritrean Nakfa [ERN].

Appendix-B presents the full range of data sources and the detailed computations that accompany table 6.1.

### 6.3 Developments from the beginning of 2003 until mid 2005:

#### 6.3.1 Government regulations:

Mid 2003 the GOE issued a regulation on import permits and declared goods (Legal Notice No. 78/2003). This regulation served as a tool to control the way in which firms spent their forex. The measure considerably limited firms in their freedom to make import decisions. It empowered the MTI to intervene in the activities of the government banks and enforced companies to import goods via the L/C system. In this way the import process became unnecessarily long and complicated. Mr. Alem argued: *'The recent government regulation on import permits has taken us back to the old system of bureaucracy.'*

As already explained, the customs office's refusal to recognise firms' actual forex costs and the fact that the tax office did not recognise the loss on exchange undermined the firms' records and performance. In addition, the government prohibited firms to obtain hard currency in parallel markets. AW&LF's management indicated: *'Now it has become difficult to operate. We have money (local currency) and know how to use it, but the regulations are preventing us from doing so. It is like watching your family starve to death but there is nothing you can do about it.'* The new regulation also required firms to declare their hard currency at the customs office and exchange it at the commercial banks at the official rates.

Further, in 2004 the Administration of the Central Zone issued a measure that enforces beverage firms to distribute their products within a restricted time range, namely from Monday to Friday between 9:00 and 12:00 a.m., including the evening hours. Mr. Rezene commented: *'The new regulation has had a huge impact on our sales performance as compared to that of other firms. For example, clients of the Red Sea Bottler's Share Company and ABF have to wait for their soft drinks and beer, since there are no other suppliers of these products. However, our clients do not have to wait, as they can also get their supplies from other sources.'* According to AW&LF's management this situation poses a considerable threat to the firm's operations. Moreover, recently the measure was extended to the Saturdays, to which the firm strongly protested. These developments show that the process of privatisation has not yet resulted in a suitable enabling environment in which firms can successfully conduct business (Abraha, 2006).

The government administers the commercial banks centrally and determines the rules and regulations with which they have to comply in their service provision and activities. So far no restrictions have been introduced with respect to loans. To some companies, the amount of collateral or the type of loan permitted may be an issue, but in general there are no major obstacles. At times AW&LF has observed that commercial banks ask companies that want to borrow money to choose for bank overdraft rather than for a short-term loan, but there is always room for negotiation. The interest charged on bank overdraft is relatively higher than in the case

of a short-time loan, but its repayment period is longer. AW&LF prefers short-term loans, however, since it always aims at settling them quickly.

### 6.3.2 Computerisation:

In 2004 the firm introduced computers for administrative and accounting purposes. They are used for keeping stock records, for recording all kinds of data and for the general register. The accounting data are processed by an Excel programme, which generates the various reports. Computerisation has greatly improved the firm's information processing and control practices, which in the early days were always performed manually. In addition, the amounts of excise and service tax to be paid can be calculated by formula specially developed for this purpose. In the beginning of 2005 the firm purchased a new computer for the Finance Department. Further, the firm is planning to install 'Peach Tree', an accounting software programme. With the aid of this programme the firm will be able to produce its reports accurately and in a timely manner. At least two accounting staff members will be trained to work with this programme. The shareholders want to install computers in all departments including in the main store.

### 6.3.3 Revisiting implementation of the business plan:

*The current situation:* At the present moment AW&LF's production processes are running smoothly. However, since 2003 sales have declined somewhat. This is why the firm's shareholders conduct market surveys on a regular basis. Besides competition, the major factors that hinder an increase in sales are the lack of hard currency and the small size of the market. Solving the problem of the lack of hard currency would certainly improve the possibilities for making investments as well as for enhancing product quality, productivity and profitability. With respect to problems such as the loss of workforce and restrictions in delivery the firm has turned to several organizations, among which the Eritrean National Chamber of Commerce, the National Confederation of Eritrean Workers, and the Employer's Federation. The firm has asked these organizations for their support in its dealings with government ministries and institutions. The intervention of these organizations has, however, been very disappointing, and the firm's circumstances have not been improved at all.

*Future plans:* As already indicated, the introduction of new technology and the implementation of the business plan are being hampered by a number of factors of external nature. For example, the firm has chosen to wait with the introduction of new machinery until it is able to hire well-educated young employees again. The present workforce, consisting of older men and women, simply do not possess the skills required for the operation of modern equipment and technology.

#### 6.3.4 The shareholders' plans and control methods:

AW&LF is run by its owners, who form its management. This is in fact unique in the Eritrean business culture, where these kinds of partnerships are not very common. Prof. Abraham indicated: *'In the past 40 to 50 years of colonisation, Eritrea has lost its resourceful people. Some of them were exiled, others died of old age, and others did not have the opportunities to own and run business firms. So there is a severe shortage of managerial capacity in the country. The problem is not the lack of capital but the lack of know-how; the lack of knowledge how to make the most of whatever little resources you have. This requires the ability to plan and to manage as well as the possession of knowledge of international marketing concepts and strategies on how to compete in the market. Here "knowledge" (the acumen and necessary skills to manage and make a business successful) is the most valuable resource, but one that our entrepreneurs lack. What Eritreans do have experience with, though, is running small business (import-export trade), either family-owned businesses or sole proprietorships. Before the liberation, the owners of family businesses managed their firms because they were theirs, not because of their knowledge. The idea of partnership was not common and corporations were completely unknown. After the liberation people started partnerships and corporations because they had the money and wanted the best for their country, but most of them did not do very well. They did not know what investments are and the risk they involve. Business people need to exercise more planning, budgeting and control practices to deal with unexpected events and force measures. The external situation should not be used as an excuse for not conducting MCS practices properly.'* The TU has a similar opinion about the way in which Eritrean entrepreneurs conduct business.

After having been expelled from Ethiopia, AW&LF's owners started a partnership, which was based on their similar background and ideas. Since then, they have put a great deal of effort in improving their management skills and increasing their insight into the market in general and the beverage industry in particular. The owners are confident that they will beat the competition of imported beverages and become market leaders. They have diversified their product lines and are continuously focussed on quality improvement. In addition, employee training programmes have been planned. However, the firm still faces problems, such as the unavailability of forex and the shortage of manpower. The plan to send employees abroad to receive training was not carried out because the risk of losing them once they had left the country was too big. To solve the forex problems and expand their investment activities, the owners tried to attract foreign investors via the Eritrean embassy in Italy, but so far this initiative has not been successful. For a concluding summary of the post-privatisation changes and developments at AW&LF, refer table 6.2.

**Table 6.2** *Summary of post-privatisation developments at AW&LF*

<b>General Changes:</b>	<ul style="list-style-type: none"> <li>- employment declined for lack of skilled labour</li> <li>- made salary increments but still remained unsatisfactory</li> <li>- employees had become committed, responsible, and conscious of quality, cost, and duty</li> <li>- employees get some benefits but no training</li> </ul>
1. Employment, training & benefits	
2. Product market decisions	<ul style="list-style-type: none"> <li>- high input and product competition</li> <li>- strategy focused on market expansion, introduction of new products and delivery of quality products</li> <li>- efforts were hindered due to government regulations</li> </ul>
3. Source of raw materials [RM]	<ul style="list-style-type: none"> <li>- high reliance on imported RMs due to lack of local sources</li> <li>- impact of government policy on access to forex, customs, record keeping and taxes</li> </ul>
4. Organisation structure	<ul style="list-style-type: none"> <li>- the owners hold top-positions, although they had no managerial training</li> <li>- trust played an important role</li> <li>- the finance department had few staff that affected the capacity for MCS changes</li> </ul>
5. Investment	<ul style="list-style-type: none"> <li>- more autonomy on investments had produced real changes</li> <li>- gave rise to reduced wastes, improved quality, productivity, efficiency and leverage</li> </ul>
<b>MCS Changes:</b>	<ul style="list-style-type: none"> <li>- no formal budgeting and planning was short-term oriented</li> <li>- knowledge of standard inputs and monthly stock balances were essential for planning and control</li> </ul>
1. Planning & Budgeting	
2. Product costing & Pricing	<ul style="list-style-type: none"> <li>- there was some mix-up in manufacturing OH costs</li> <li>- cost estimates were quarterly updated</li> <li>- costs and product prices were greatly affected by external contextual factors</li> </ul>
3. Internal reporting & Decision-making	<ul style="list-style-type: none"> <li>- reporting to the MTI was standardised</li> <li>- the owners encouraged use of past MCS practices with some modifications</li> <li>- decisions were made fast by the owners who frequently had informal contacts</li> <li>- computerisation has introduced improvements</li> </ul>
4. Cost control & Waste minimisation	<ul style="list-style-type: none"> <li>- input-output relationships were standardised and often used for controlling resources</li> <li>- requirements for containers was effectively planned and their breakage checked</li> <li>- labour requirements were effectively monitored to reduce costs</li> <li>- quality was regularly controlled</li> <li>- non-financial information was utilised as input for improvements</li> </ul>
5. Performance measurement and evaluation	<ul style="list-style-type: none"> <li>- internal reports and physical supervision were helpful to evaluate performance</li> <li>- financial analysis was conducted annually</li> <li>- poor profitability and fluctuating labour productivity, sales efficiency and output</li> <li>- the BOD met monthly to facilitate its activities</li> <li>- competition and other external factors significantly affected performance</li> </ul>

## 6.4 Discussion and Conclusions

In this chapter we have discussed the changes in MCS practices and firm performance of the Asmara Wine & Liquor Factory during the transition period to privatisation period. We have described to what extent the firm has been able to implement its business and investment plans. In our analysis we have included internal as well as external contextual factors, which have played a role in the firm's development process. Despite the significant challenges, the firm has succeeded in implementing part of its business plan. For example, it has repaired its old machinery and purchased new equipment as well as delivery trucks, it has improved its production areas and renovated its buildings, it has realised waste reduction, and diversified its

product lines. The CES and CEA ratios (see table 6.1) depict these results. The investment in assets significantly reduced the leverage ratios (as measured by DAR). In addition, the firm is especially focussed on improving the quality of its products. Further, to increase its understanding of the market it conducts surveys on a regular basis. It has even been able to increase the salaries of its employees. However, external factors such as the abolishment of the forex services in 2001 have hampered the full realisation of the business plan. This abolishment forced the firm to obtain forex on the black market at higher rates, which increased its manufacturing costs and narrowed its profit margin. In addition, since mid 2003 it has become difficult to import raw materials due to the introduction of strict regulations. Further, the firm was prohibited to base its records on the actual price paid for forex. As a result, the accuracy of its records was severely undermined.

In accordance with the rules of the Customs Office and the Department of Inland Revenue (DIR) the actual value of imported items has to be converted to the value in local currency by means of the official exchange rates. In this way the actual price paid to obtain forex is not taken into account, resulting in a loss on exchange. The DIR does not treat loss on exchange as an expense. Instead it re-adds it to the operating income before tax levy, which artificially raises the operating income and consequently the taxes. As a result AW&LF sustained heavy losses and its import activities were hampered. Finally, in 2004 a regulation was issued that prohibited the purchase of forex on the black market. This meant the end of the firm's import operations, which had significant implications for its production. The production process has become much more vulnerable, since for its empty bottles the firm is now dependent upon its clients and raw materials have to be acquired locally. In addition, the strict time schedules of the distribution of goods in the capital city have decreased the firm's sales levels and market share.

Except for some modifications, the accounting methods applied by the firm are about the same as those used in the public ownership period. These modifications concern systems for the control of bottles and annual sales forecasts that serve as estimates rather than targets. The purchase of materials is determined by demand based on the sales activities and the availability and price of forex on the black market. So the planning of obtaining raw materials is very much influenced by short-term events. Further, as the firm's owners determine the firm's operations, the decision-making process has significantly improved. They have developed clear strategies to increase product quality as well as productivity and sales. More investments in technology are planned in the near future. In addition, computerisation has made it possible to deliver timely and accurate management and control information. On the basis of our findings, the nature of MCS at AW&LF can be classified as a mixture of diagnostic and belief systems. The factory does not prepare formal budgets, but it exercises short-term production plans. The concept of standard costing is utilised by the firm and it measures resource consumption, monitors production, and attempts to reduce costs and waste. Generally, the factory has reduced the

amount of paper work associated with its MCS practices relative to its current size. Thus, MCS has become more cost effective and efficient.

The obligatory military service has created a shortage of qualified young employees and accountants in the labour market. Due to this shortage as well as the present economic situation the firm has been forced to raise its employees' salaries in order to retain them. However, because of the increasing costs of living these higher salaries are not satisfactory to the employees. However, in spite of all these problems AW&LF has succeeded in motivating its present workforce to stay with the firm, and it managed to instil a sense of responsibility in them. Compared to general standards, though, the workforce is small. The Finance Department is run by a part-timer, and there is no internal auditor. Moreover, most of the staff members have no college degree. This means that the firm is not sufficiently equipped to facilitate changes in its management and control practices. In addition, because the firm's management and other shareholders lack managerial and accounting skills, its capacity to undertake action is minimal. The shareholders do their best to catch up on their knowledge and skills, however, and also stimulate the other departments to improve their ways of working. In general, all steps in the input and output processes are recorded. In addition, sales analyses are made on a daily, weekly, monthly and quarterly basis. Some procedures adopted in the public ownership period have been abolished. The working hours have been adjusted to enhance productivity. With respect to determining costs, we observe that non-production costs (e.g. depreciation of buildings) are included in the overhead costs. Further, the application rate does not reflect the actual resource consumption, because it is based on the same amount for each litre of beverage that leads to inaccurate information. As the capacity utilisation is currently low, the overhead costs are, relatively speaking, too high. Although, the senior managers are complaining about low competitor prices, they have failed to investigate their own costs in order to find rooms for cost reduction.

Table 6.1 shows that until 2001 the firm managed to improve its sales, labour productivity, operating efficiency, and output. After that, its performance declined. So what we can see is an increase in firm performance after the introduction of privatisation, which lasted for three years. The decline after this period can be explained by several external contextual factors, such as the abolishment of forex services, inflation (which increased the manufacturing costs), the shortage of bottles, the import of similar products, the competition of small local businesses, governmental regulations, and the obligatory participation in the military. In addition, at times the quality of the water is poor, which is of course specifically problematic to manufacturers of beverages. Further, an aspect to which the firm could have paid more attention is cost reduction. In addition, taxes are an issue to the firm; these are unfair in comparison with the taxes that firms in other industries have to pay. Another external factor that AW&LF has to deal with is the status-orientedness of the local customers and the fact that at the same time they do not appreciate quality. They are inclined to buy the expensive imported beverages, even though

these are of lesser quality. Foreigners, however, prefer to buy the local drinks. To tackle this problem, the shareholders decided to design new labels that do not show that the beverages are manufactured locally.

Future improvements are clearly related to government measures in the areas of labour, forex, product distribution, advertising possibilities, and taxation. In addition, in order to improve its MCS practices and information provision AW&LF has to hire more qualified people and offer training to its present staff. Computerisation obviously plays an important role in this process. So a mixture of internal and external measures is required to ensure a successful implementation of the firm's business plan and to improve its performance. These measures are in fact crucial for the survival of all Eritrean businesses.



